1991

Savings institutions industry developments - 1991; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Savings Institutions Industry Developments—1991

Update to AICPA Audit and Accounting Guide *Audits of Savings Institutions*

AICPA
American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors of financial statements of savings institutions with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

Gerard L. Yarnall
Director, Audit and Accounting Guides

James F. Green
Technical Manager, Federal Government Division

1 2 3 4 5 6 7 8 9 0 AAG 9 9 8 7 6 5 4 3 2 1

Table of Contents

Savings Institutions Industry Developments—1991

Industry and Economic Developments

A weakened economy, increased competition, and continued reregulation have presented significant challenges to the savings institutions industry during 1991.

The effects of recession have hindered the resolution of troubled institutions while undercutting the recovery of many surviving institutions. Real estate values have continued to decline or stagnate in many parts of the nation, and the holdings of the Resolution Trust Corporation (RTC), the agency charged with the resolution of insolvent institutions, continue to grow as assets acquired exceed those sold. The combination of large volumes of RTC assets with a soft national real estate market has further impaired the assets of many surviving thrifts and has significantly curbed new lending opportunities. Accordingly, problems with asset quality, liquidity, and capital adequacy have intensified.

Challenges have also intensified as a consequence of the shrinking of the industry. In an effort to meet increased capital and other requirements mandated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), many institutions have pursued opportunities to either consolidate within the industry or convert to banks. At the same time, increasing regulatory restriction of thrift activities and a shrinking sphere of permissible investments have diminished the competitive advantages that surviving institutions may otherwise have had over banks. The result is heightened competition between those savings institutions that have been strengthened through consolidation, newly converted banks, existing banks, and the remaining institutions.

Finally, the reregulation of savings institutions, brought about by the passage of FIRREA, has advanced significantly during 1991. As discussed in the section "Regulatory and Legislative Developments," increasing regulatory requirements for savings institutions and enhanced enforcement powers granted federal banking regulators have intensified the risks faced by both regulated institutions and the auditors of their financial statements.

Auditors should be alert to red flags that may indicate noncompliance with or violation of rules and regulations of the Office of Thrift

Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC); inadequacies with respect to timing and amount of loan-loss provisions and write-offs; unacceptable accounting practices; and increased risk of material misstatements, errors or irregularities, and insider abuse. Such red flags include—

- Material, one-time transactions, which may indicate attempts to realize large, short-term benefits, particularly when such transactions occur at or near the end of a reporting period or account for a material portion of reported income. Such transactions may include high-volume purchases or sales of assets (such as mortgage-servicing rights), speculative or unusual off-balance-sheet arrangements, large dividend distributions, significant gains on sales of securities or loans held for investment, significant turnover in the institution's investment portfolio, and other high rates of asset growth or disposition. Auditors should give particular attention to the propriety of the accounting treatment of such transactions.
- Participation in new, highly complex, or speculative investments, such as complex mortgage derivatives; investments in non-investment-grade securities; or complicated, multiple-step transactions involving real estate. Auditors should consider the propriety of management's valuation of such investments and evaluate management's assessment of their recoverability.
- Nontraditional or unusual loan transactions, which may expose the institution to increased risk. Such transactions include loans with unusual, questionable, or inadequate collateral; loans outside the institution's normal lending area; poorly documented loans; loans that pay interest from interest reserves; loans secured by collateral that has dramatically changed in value; significant concentration of loans; loans to real estate ventures that represent equity investments (acquisition, development, and construction loans); and practices such as routine extension or modification of loan terms or lending activity inconsistent with management's stated policies.
- Material changes in operations or operating performance, which may indicate deteriorating financial strength. Such changes include growing dependence on brokered deposits, significant changes in the nature or volume of hedging activity, high levels of administrative expenses in relation to industry averages, management compensation that is inconsistent with the institution's performance, increasing loan delinquencies, nonperforming assets or loss chargeoffs, declining net-interest spreads, interest rates on deposits that are higher than those paid by competitors,

low or declining levels of loan-loss allowances relative to nonperforming loans (compared to industry averages), and practices that reflect a failure to consider changing economic conditions (such as overreliance on historical data in evaluating allowances for loan losses).

Other indicators of increased risk include evidence of illegal or questionable acts; accounting practices that are overly aggressive or overly conservative; highly complex operating structures (for example, intricate parent-subsidiary relationships); events of default on debt, interest payments, or both; severe asset-liability mismatch; poor credit-risk management; and noncompliance with or termination of third-party contracts (for example, loss of the right to service loans for a secondary mortgage market agency).

Indicators such as these require an understanding of the circumstances surrounding the specific situation. Auditors should carefully consider whether such events or transactions create, intensify, or mitigate risk to the institution.

Regulatory and Legislative Developments

Regulatory scrutiny has increased during 1991 due to persistent earnings difficulties, the weakened economy, and the ongoing financial problems of savings institutions. Institutions have been required to adapt to the post-FIRREA regulatory structure, including scheduled increases in certain regulatory capital requirements. The resulting regulatory environment presents factors that may increase audit risk. Such factors include those discussed below.

Regulatory Examinations

Regulatory authorities such as the OTS and the FDIC sometimes mandate that savings institutions establish loan-loss allowances for regulatory accounting principles (RAP) that differ from amounts recorded in financial statements prepared under generally accepted accounting principles (GAAP). In recent years, regulatory examinations and other regulatory activities have highlighted such differences. In order to help both auditors and regulatory examiners to better understand the nature of such differences, several regulatory agencies have published guidance setting forth their loan-loss rationales.

On May 7, 1991, the FDIC issued a memorandum, *Allowance for Loan and Lease Losses,* that provides guidance to agency examiners on assessing the adequacy of loan-loss allowances and discusses related accounting literature. The memorandum also helps examiners highlight differences between regulatory and institution allowance rationales. For example, OTS and FDIC policies have generally considered specific reserves equivalent to chargeoffs (that is, direct reductions of the related loan balances). However, the memorandum states that FDIC examiners may determine that some portion of an institution's specific reserves should be reclassified into its general reserves.

In March 1991, the FDIC, the OTS, the Federal Reserve Board (FRB), and the Office of the Comptroller of the Currency (OCC), issued joint statements and guidelines to clarify certain of their regulatory and accounting policies, particularly those concerning loan-loss allowances. The statements and guidelines were issued to encourage increased disclosure about loan portfolios, mitigate the perceived tightening of credit availability attributed to increased regulatory scrutiny, and ensure proper valuation of collateral real estate.

In September 1991, the OTS, the FDIC, the FRB, and the OCC each submitted reports to Congress addressing interagency differences in capital and accounting standards. In its report, the OTS announced its intention to propose a new policy for valuation of troubled, collateral-dependent loans and foreclosed real estate that would require the use of fair value rather than net realizable value.

The Emerging Issues Task Force (EITF) of the Financial Accounting Standards Board (FASB) reached a consensus on Issue No. 85-44, *Differences Between Loan Loss Allowances for GAAP and RAP,* which states that institutions can record different loan-loss allowances under RAP and GAAP as the amounts computed by preparers of financial statements and regulators may differ due to the subjectivity involved in estimating the amount of loss or the use of arbitrary factors by regulators, but that auditors should be particularly skeptical of such differences and must justify them based on the facts and circumstances.

Capital Requirements

Changes in regulatory capital requirements during 1991 have included new limitations on and revised classifications of certain components of regulatory capital. In addition, a revised core-capital ratio requirement is expected by the end of 1991.

The tangible capital requirement is 1.5 percent of assets. In March 1991, the FDIC published its final rule limiting the amount of purchased mortgage-servicing rights (PMSR) not deducted in determining regulatory capital to be the lesser of (a) 90 percent of the PMSR original purchase price, (b) 90 percent of the PMSR fair market value, or (c) 100 percent of the PMSR unamortized book value. The rule also states that the amount of PMSR not deducted in calculating tangible capital may not exceed the lesser of 100 percent of tangible capital (before deduction of any excess PMSR) or the amount determined above. The FDIC's final rule directly limits the amount of PMSR that savings institutions can recognize in core capital to no more than 50 percent of core capital. PMSR are the only intangible assets not deducted in determining tangible capital.

The required minimum ratio for core capital is currently 3.0 percent of total assets. However, the OTS is expected to issue a final rule in late 1991 that would increase the requirement to 4.0 percent to 5.0 percent for institutions with ratings of MACRO 2 through MACRO 5. The determination of core capital, unlike that of tangible capital, does not require the immediate deduction of all unamortized supervisory goodwill arising from the purchase of a troubled institution prior to April 12, 1989. However, unamortized supervisory goodwill is being deducted on a phased schedule and will be fully deducted from core capital by January 1, 1995.

The minimum total risk-based capital ratio (that is, the total of core and supplemental capital) increased to 7.2 percent of risk-weighted assets on December 31, 1990, and will increase to 8.0 percent on December 31, 1992. The minimum requirement for core capital included in total risk-based capital increased to 3.6 percent of risk-weighted assets as of December 31, 1990, and will increase to 4.0 percent on December 31, 1992. The OTS has postponed the introduction of an interest-rate risk component to risk-based capital until 1992 to permit further field testing.

Regulatory agencies continue to discuss whether certain items—including identified intangibles (other than PMSR), excess servicing, and recourse sales—must be deducted from available supplemental capital. The OTS has issued instructions for Thrift Financial Reports prohibiting inclusion of acquired general-valuation allowances (GVAs) in supplemental capital. The OTS staff has generally expressed the belief that allowances arising from purchase accounting adjustments and allowances that were previously on the acquired institution's balance sheet are not includable, because they have not previously been recognized in the income statement of the acquiror.

The OTS has also been reviewing whether foreclosed assets related to acquisition, development, and construction (ADC) loans should be classified for regulatory capital purposes as investments or real estate owned. In one instance, raw land was classified as an investment, although developed real property has been classified as real estate owned. The classification of these types of transactions may have significant regulatory capital consequences.

An institution that is not in compliance with regulatory capital requirements may be required to submit a detailed plan for achieving compliance with the capital standards and its ability to grow may be restricted. In certain cases, an institution may be granted an exception, allowing growth up to the amount of net interest credited to its deposit liability accounts.

Because of the complexity of the capital regulations, their application requires a thorough understanding of specific requirements and the potential impact of any instance of noncompliance—particularly when an institution is involved either in complex parent-subsidiary relationships or in transactions or investments (such as complex mortgage-derivative securities or recourse liabilities) that are difficult to classify according to the risk-weighting categories.

Qualified-Thrift-Lender Test

To be considered savings institutions, institutions are required to hold a specified portion of their assets in eligible housing-related assets. Beginning July 1, 1991, the OTS increased the minimum percentage from 60 percent to 70 percent. Among other modifications to the qualified-thrift-lender (QTL) test, the OTS final rule redefines both qualified thrift investments includable in the numerator of the test ratio, and portfolio assets includable in the ratio denominator. The final rule also revises the computation period and the requirements for requalifying after failing the QTL test.

Institutions that fail to comply with the QTL requirement are subject to restrictions on investment activities, branching rights, and access to Federal Home Loan Bank advances. These institutions may also be required to operate as a bank and convert to a bank charter. An institution that fails the OTS QTL test may also fail the separate Internal Revenue Service QTL test.

Investment Practices

As of late 1991, the Federal Financial Institutions Examination Council (FFIEC) had not finalized its proposed supervisory policy statement on securities activities. Among other matters, the proposed policy statement would (a) provide guidance on permissible activities within an investment portfolio accounted for at historical cost, (b) specify responsibilities of the institution's management and board of directors for oversight of investment activities, and (c) establish a three-part test for identifying high-risk mortgage securities (such as stripped mortgage-backed securities). The policy would also place restrictions on investments in high-risk mortgage securities.

The three-part test includes measurement of the security's weighted-average life, the sensitivity of that life to future changes in interest rates, and the estimated change in the security price caused by future changes in interest rates. As proposed, the policy would require that institutions hold or acquire high-risk mortgage securities only to reduce interest-rate risk and that, for supervisory reporting purposes, such securities be carried either as trading assets at market value or as assets held for sale at the lower of cost or market value.

Transactions With Affiliates

In July 1991, the OTS adopted a final rule on savings institutions' transactions with affiliates (TWA) that applies sections 23A and 24A of the Federal Reserve Act to savings institutions, as required by FIRREA. The final rule defines affiliates, limits transactions with affiliates to 10 percent of capital stock and surplus (as defined in the regulation), and limits aggregate transactions with all affiliates to 20 percent of capital stock and surplus (as defined). The final rule also revised the scope of the OTS's loans-to-one-borrower (LTOB) rule to ensure that the TWA and LTOB rules are complementary.

The FDIC has also proposed regulations that would further restrict transactions between insured depository institutions and their affiliates and service providers.

Thrift Administration Review Program

The OTS is developing a program to encourage savings institutions to improve record keeping and internal controls, including possible auditor reports on matters related to records and related controls. The plan, known as the Thrift Administration Review Program (or TARP), would mandate adequate records—especially for troubled assets—and is aimed at ensuring the safety and soundness of institutions, improving examination efficiency, and preserving information that would be needed by the Resolution Trust Corporation in the event of the seizure of an institution.

Professional Liability

In addition to increasing regulators' enforcement powers, FIRREA expanded the population of those held accountable for regulatory violations to include institution-affiliated parties. Institution-affiliated parties are defined to include accountants who are not otherwise participants in the affairs of a financial institution and who "knowingly or with reckless disregard participate in (a) any violation of any law or regulations; (b) any breach of fiduciary duty; or, (c) any unsafe or unsound practice, which caused or is likely to cause more than a minimal financial loss to, or significant adverse effect on, the insured depository institution." Regulators have increased the frequency of enforcement actions against professional advisors, including accountants.

Other Regulatory Trends

The post-FIRREA regulatory structure has created unique considerations for savings institutions. The existence of both a primary and a secondary regulator (the OTS and the FDIC, respectively), means that institutions may be subject to two regulatory examinations and, accordingly, differences may exist between the examination procedures applied by the two agencies. As savings institutions continue to adapt to post-FIRREA regulatory processes and procedures, regulatory guidance and interagency consistency continue to develop.

Legislative Developments

Congress has proposed banking reform bills that, if adopted, would significantly affect insured depository institutions. Among other provisions, the bills include proposals for deposit insurance reform, recapitalization of the Bank Insurance Fund (BIF), authorization of interstate activities, expansion of products and services, and changes in regulatory requirements. The proposals also include provisions for mandatory audits of financial statements of all institutions and management and auditor reporting on internal control structure and compliance with specified laws and regulations for institutions with assets in excess of $150 million, unless they are holding company subsidiaries. Annual regulatory examinations and additional reporting would also be required for institutions with certain levels of assets or specified regulatory ratings.

Information Sources

OTS regulations and statements of policy are codified in section 12 of the Code of Federal Regulations. OTS supervisory policies and guidance are issued in the form of Thrift Bulletins, Regulatory Bulletins, Legal Alert Memos (for issues relating to public registrants), Transmittals, and guidance provided to examiners through a multivolume set of agency handbooks. Generally, all this information can be obtained by contacting the Office of Communications of the OTS.

FDIC guidance can also be found in the Code of Federal Regulations, in instructions for consolidated reports of condition and income (Call Reports, available through the FFIEC), and in letters to financial institutions, advisory opinions, interpretive letters, and statements of policy. In addition, several reference services publish OTS and FDIC rules and regulations, statements of policy, bulletins, memos, and releases.

Audit and Accounting Guide

In September 1991, the AICPA issued an Audit and Accounting Guide *Audits of Savings Institutions,* which supersedes the 1979 AICPA

Audit and Accounting Guide *Savings and Loan Associations*. The principal objective of the guide is to help independent auditors audit and report on the financial statements of savings institutions and savings banks insured by the Savings Association Insurance Fund (SAIF) of the FDIC.

Another significant objective of the guide is to heighten auditor awareness of audit risks and of the complex issues encountered in an audit of the financial statements of a savings institution. The guide provides important information about interest-rate risk, liquidity, asset quality, and internal control structure. It also emphasizes the need for the auditor to become familiar with the industry, and to have training or experience in auditing areas of particular complexity, such as mortgage-related derivatives and off-balance-sheet financial instruments.

The guide does not establish any new accounting or financial reporting standards; rather, the provisions of the guide describe existing practices and authoritative accounting literature (although the guide does establish specialized industry practices for marketable equity securities, which are discussed in paragraph 14 of FASB Statement No. 12, *Accounting for Certain Marketable Securities*). Significant accounting matters addressed in the guide include evaluating the adequacy of the allowance for credit losses and valuing real estate acquired. The auditing provisions of the guide are to be applied prospectively to audits of financial statements of savings institutions for fiscal years beginning after December 31, 1990.

Audit Issues

Noncompliance With Regulatory Requirements. Events of noncompliance with regulatory requirements, such as failure to meet minimum capital requirements or participation in impermissible activities or investments, expose savings institutions to regulatory action. Events of noncompliance may be brought to the auditor's attention during the application of normal auditing procedures, during the review of regulatory examination reports, or as a result of actions required by regulators.

AICPA Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, states that "the auditor has a responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited." Noncompliance or expected noncompliance with regulatory capital requirements is a condition, when considered with other factors, that could indicate substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Other factors that should be evaluated are identified in SAS No. 59.

Loan-Loss Allowances. The deteriorating credit quality of loans, particularly commercial real estate loans but also consumer loans and other commercial loans, continues to be a very serious problem for savings institutions. Adverse economic conditions (described in the "Industry and Economic Developments" section) and intensified regulatory scrutiny (described in the "Regulatory and Legislative Developments" section) combine to make auditing loan-loss allowances one of the most critical audit areas in every savings institution audit. Auditors should obtain reasonable assurance that management has recorded an adequate allowance, based on all factors relevant to the collectibility of the loan portfolio. Loan-loss allowances are based on subjective judgments and are difficult to audit. Generally, failure by an institution to adequately document the criteria or methods used to determine loan-loss allowances will require both regulatory examiners and auditors to make more subjective judgments when evaluating the adequacy of the allowances and will increase the likelihood that differences will result. Accordingly, careful planning and execution of the audit procedures in this area are essential.

The guidance in SAS No. 57, *Auditing Accounting Estimates,* is particularly useful in this area. Additional information on auditing loan-loss allowances is provided in the AICPA Auditing Procedure Study *Auditing the Allowance for Credit Losses of Banks.*

In-Substance Foreclosures. Dealing with nonperforming real estate loans for which the fair value of collateral has declined and is less than the amount owed is particularly troublesome. Auditors should consider whether savings institutions have identified loans that meet the criteria for in-substance foreclosure set forth in AICPA Practice Bulletin 7, *Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed,* and in the Securities and Exchange Commission's (SEC's) Financial Reporting Release 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities,* and whether the accounting treatment of such loans is appropriate.

Accounting Developments

Accounting for Income Taxes

In June 1991, the FASB exposed for comment a proposed Statement, *Accounting for Income Taxes,* which, if adopted, would supersede FASB Statement No. 96, *Accounting for Income Taxes.* Among other provisions (which are more fully described in *Audit Risk Alert—1991*), the proposed Statement would preclude recognition of the tax benefit of a book bad-debt reserve of a savings institution when that reserve is exceeded by the institution's tax bad-debt reserve.

In July 1991, the staff of the SEC issued Staff Accounting Bulletin (SAB) No. 91, which establishes preferability of the one-difference or cumulative method of accounting for income tax benefits of bad-debt reserves in savings institution financial statements filed with the SEC. The bulletin was released pending the issuance of a final Statement by the FASB. The bulletin permits prospective adoption of the one-difference or cumulative method, provided certain footnote disclosures are made, and states that benefits previously recognized under other methods are subject to reversal when realized. Although the bulletin does not alter the guidance of paragraph 23 of Accounting Principles Board Opinion No. 23, *Accounting for Income Taxes—Special Areas*, there is a presumption that taxes will be paid on any increase in tax reserves in excess of the institution's base-year tax reserve. In August 1991, the OTS issued Thrift Bulletin No. 49, which requires institutions that make securities filings with the OTS to comply with SAB No. 91.

FASB Financial Instruments Project

The FASB's current agenda includes a project on financial instruments that encompasses three primary segments: disclosures, distinguishing between liabilities and equity, and recognition and measurement. In addition to these three primary segments, the FASB is addressing several narrower issues within the overall scope of the project. Some of the current developments of the project are described below.

Market-Value Disclosures. In December 1990, the FASB issued an exposure draft of a proposed Statement, *Disclosures about Market Value of Financial Instruments.* The proposed Statement would require disclosure of the market value of all financial instruments, both assets and liabilities on and off balance sheet, for which it is practicable to estimate market value. Descriptive information pertaining to estimating the value of financial instruments for which it is not practicable to estimate market value would also be required to be disclosed. Certain financial instruments (for example, lease contracts, deferred compensation arrangements, and insurance contracts) are excluded from the scope of the proposed Statement. The FASB is expected to issue a final Statement in late 1991. However, the Statement will not be effective for 1991 year-end reporting.

Right of Offset. In June 1991, the FASB issued an exposure draft of a proposed Interpretation of Statement No. 105 and Accounting Principles

Board Opinion No. 10 that would prohibit offsetting amounts recognized for swaps, forwards, and similar contracts unless a right of setoff exists. The proposed Interpretation, *Offsetting of Amounts Related to Certain Contracts,* defines right of setoff and specifies conditions that must be met to have that right. The proposed Interpretation also addresses the applicability of the right-of-setoff principle to forward, interest-rate swap, currency swap, option, and similar contracts, and clarifies the circumstances under which related amounts could be offset in the statement of financial position. It also provides an exception to the general principle to permit offsetting of market-value amounts recognized for multiple forward, swap, and similar contracts executed under master netting arrangements. The FASB expects to issue a final Interpretation sometime in 1992.

Investments With Prepayment Risk. In September 1991, the FASB issued an exposure draft of a proposed Statement, *Accounting for Investments with Prepayment Risk,* that would require anticipation of prepayments in the projection of cash flows used in the measurement, after acquisition, of certain investments whose cash flows vary because of prepayments when the prepayments are considered probable, can be reasonably estimated, and have a significant effect on the effective yield. The proposed Statement also specifies that when prepayments are anticipated and actual prepayments differ from those assumed or projections change, the effective yield from inception should be recalculated to reflect actual payments to date and anticipated future payments. The net investments would be changed to the amount that would have existed had the new yield been applied since the acquisition of the investment. The proposed Statement also provides guidance on the calculation of the effective yield for variable-interest-rate instruments subject to prepayment. The FASB expects to issue a final statement in 1992.

Marketable Securities. The FASB has begun discussion of a project that entails consideration of whether to require that investments in marketable securities, and perhaps some other financial assets, be measured at market values. As part of the project the FASB will also consider the feasibility of permitting entities the option of reporting some liabilities at market value. This project was added to the FASB's agenda partially in response to requests from the SEC, the AICPA, and others that the FASB undertake a limited-scope project to consider market-value-based accounting for investments in debt securities held as assets. The FASB expects to issue an exposure draft in 1992.

Impairment of a Loan. The FASB is considering whether creditors should measure impairment of loans with collectibility concerns based on the present value of expected future cash flows related to the loan. This issue arose out of requests from the Accounting Standards Executive Committee (AcSEC) and the FDIC that the FASB resolve whether creditors should discount expected net future cash flows from the underlying collateral of a loan when determining the appropriate loss allowance for that loan. The FASB is expected to issue an exposure draft in 1992.

Consensus Decisions of the FASB's Emerging Issues Task Force

The EITF frequently discusses accounting issues involving financial instruments, real estate, or transactions of similar importance to savings institutions.

At its July 1991 meeting, the EITF reached a consensus on Issue No. 90-21, *Balance Sheet Treatment of a Sale of Mortgage Servicing Rights with a Subservicing Agreement,* that a sale of mortgage servicing rights with a subservicing agreement should be treated as a sale with gain deferred if substantially all the risks and rewards inherent in owning the mortgage servicing rights have been effectively transferred to the buyer. At its September 1991 meeting, the EITF reached a consensus on factors to be considered when determining whether substantially all the risks and rewards inherent in owning the mortgage-servicing rights have not been transferred to the buyer, thereby requiring that the transaction be accounted for as a financing.

As specified in the minutes, the seller's retention of title to the servicing rights or certain guarantees, advances, and indemnifications provided in the transaction are factors that would clearly require the transaction to be accounted for as a financing. Certain other factors are also specified that, if present, create a rebuttable presumption that substantially all the risks and rewards have not been transferred.

AcSEC Activities

Accounting for Foreclosed Assets. In August 1991, AcSEC approved a proposed Statement of Position (SOP), *Accounting for Foreclosed Assets,* for final issuance. The SOP includes a presumption that foreclosed assets are held for sale and requires foreclosed assets to be classified in the balance sheet as assets held for sale and reported at the lower of (a) fair value minus the estimated costs to sell or (b) cost. In addition, the net amount of revenues and expenses related to foreclosed assets would be charged or credited to income as a net gain or loss on holding foreclosed assets. Capital additions, improvements, or any related capitalized interest would be added to the cost basis of the asset. No depreciation, depletion, or amortization expense related to foreclosed assets would be recognized. The SOP would be applied to all foreclosed assets in annual financial statements for periods ending on or after June 15, 1992. The proposed SOP has been sent to the FASB for clearance prior to final issuance.

ADC Arrangements. An AcSEC task force is developing a proposed Practice Bulletin, *ADC Arrangements and Similar Arrangements that are Classified as Real Estate Investments or Joint Ventures,* to provide implementation guidance on accounting for acquisition, development, or construction (ADC) arrangements under the February 10, 1986, Notice to Practitioners, *ADC Arrangements*. In particular, the proposed Practice Bulletin is expected to address—

- How lenders should report their proportionate shares of income or loss on ADC projects.
- Whether depreciation should be considered in determining the income or loss to be recognized.
- How lenders should report their interest receipts.
- Whether unrealized appreciation of the property should be considered in determining income or loss to be recognized by the lender.

The project is also expected to address the relationship between a lender's proportionate share of income or loss and its "expected residual profit," as described in the Notice to Practitioners.

Interest Income on Impaired Assets. An AcSEC task force is developing an Issues Paper, *Financial Reporting of Interest Income on Troubled or Past Due Loans by Financial Institutions.* Among the questions the task force is addressing are:

- When should lenders cease accruing interest on troubled loans?
- How should lenders account for interest accrued but uncollected?
- What disclosures are appropriate for cash payments received on nonaccrual loans?

Loan Splitting. In March 1991, the FFIEC published a proposal to establish criteria that would have permitted depository institutions to return certain nonaccrual loans to accrual status without first recovering any partial chargeoffs or without the loans being fully current. The proposal received significant attention and, in August 1991, it was withdrawn by the FFIEC. Among the reasons cited for withdrawal of the proposal were concerns about inconsistencies between the proposal and GAAP as well as the existence of current projects addressing similar impairment issues being undertaken by the FASB (for example, its financial instruments project, which is considering measurement and reporting issues) and by the AICPA (including the proposed Issues Paper on interest income on impaired assets discussed above). Earlier, the SEC had issued an interpretive release that stated that the use of the accounting method would be unacceptable in SEC filings.

Ethics Development

Prohibition of Loans to and From Clients

The AICPA Professional Ethics Executive Committee has issued a revised interpretation of the independence rules relating to loans to and from clients. No change was made to the current rule prohibiting loans to and from clients that are not financial institutions. The revised interpretation, effective January 1, 1992, prohibits all loans from financial institution clients except automobile loans and leases, credit-card and cash-advance balances that do not in the aggregate exceed $5,000, loans on the cash surrender value of life insurance policies, and loans collateralized by cash deposits (passbook loans).

Loans permitted under current ethics interpretations are grandfathered; however, the value of collateral on a secured loan must equal or exceed the remaining balance of the loan at January 1, 1992, and at all times thereafter. The revised interpretation was printed in the November 1991 issue of the *Journal of Accountancy.*

* * * *

This Audit Risk Alert supersedes *Savings Institutions Industry Developments—1990.*

* * * *

Auditors should also be aware of the economic, regulatory, and professional developments that may affect the audits they perform as described in *Audit Risk Alert—1991* (Product No. 022087). *Audit Risk Alert—1991* was printed in the November 1991 issue of the *CPA Letter.* Additional copies can be obtained from the AICPA Order Department.

Copies of AICPA publications may be obtained by calling the AICPA Order Department at (800) 334-6961 (outside New York) or (800) 248-0445 (New York only). Copies of FASB publications may be obtained directly from the FASB by calling the FASB Order Department at (203) 847-0700, ext. 10.

022084